

TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: General- Benchmark Modification Policy
(Tobacco Industry)

ITEM NUMBER: 5

ATTACHMENT(S): 2

ACTION: X

DATE OF MEETING: June 7, 2000

INFORMATION: _____

PRESENTER(S): PCA, Allan Emkin

EXECUTIVE SUMMARY

In the May 2000 Investment Committee, a Benchmark Policy and Benchmark Modification Policy were adopted following a review and discussion. The adopted policies have been provided as Attachment 1.

The Investment Committee directed staff and Pension Consulting Alliance (PCA) to provide a written analysis specific to the tobacco industry as it pertains to the Benchmark Modification Policy. This analysis has been provided as Attachment 2.

RECOMMENDATION:

After reviewing the Benchmark Modification Policy (Policy), staff recommends and PCA concurs that all of the elements identified in the Policy have been indicated. The Investment Committee has completed the necessary procedural and substantive due diligence required to modify the existing benchmark.

The purpose of a benchmark, as identified in the Investment Management Plan, is “To facilitate the periodic reporting to the Investment Committee and to provide a relative measure to gauge success, custom performance benchmarks are approved by the Board.”

BENCHMARK POLICY

1. The Investment Committee approved performance benchmarks are used in the asset allocation process for modeling purposes. The approved benchmarks are contained in the Investment Management Plan.
2. There are four characteristics identified as desirable in the selection of an appropriate benchmark.
 - (A) Unambiguous -- The names and weights of the securities in the benchmark should be clearly defined.
 - (B) Investable -- The securities contained in the benchmark should represent tradable positions. Ideally, the benchmark should be constructed with low turnover (companies should not change too much over time) to minimize transactions costs.
 - (C) Measurable -- The pricing of the benchmark should be transparent making it possible to track the benchmark's performance. The benchmark will, whenever practical, be calculated independently and available to the public on a daily basis (applies to publicly traded asset classes only). Appropriate -- As part of the investment planning/policy process the Investment Committee will adopt an asset class benchmark (reference portfolio) that reflects the broad risk and return characteristics of that asset class. The benchmark will be the reference portfolio against which the aggregate active and passive portfolios within that asset class will be measured.
3. As a matter of practice the approved benchmark will be reviewed by the Investment Committee on an annual basis to assure that it continues to reflect the risk/return characteristics of the asset class in a cost-effective manner. Strategic asset allocation assumptions will be based upon expected risk, return, and correlation coefficients of the approved benchmark.

BENCHMARK MODIFICATION POLICY

1. Asset class benchmarks may be modified when it is in the economic interest of the System.
2. Benchmark modification indicators are identified as:

- A. When a more cost efficient (expenses such as trading costs or transaction fees) alternative is available that captures the risk return characteristics of the asset class.
- B. When an industry or sector (component) of the benchmark is exposed to economic risks that are of such a degree that the future economic viability of that industry or sector is in doubt. Specific indicators are:
 - (1) The industry, not an individual company, shares common exposure to product liability judgements (including, but not limited to, potential judgements involving overwhelming punitive damage awards), settlements, and ongoing litigation that have the potential to exceed the industry's net worth.
 - (2) Significant threat of industry-wide bankruptcy filings.
 - (3) Regulatory and/or legislative actions that have the potential to substantially impair industry-wide earnings.
 - (4) Policy actions in the institutional investor community that, in aggregate, have the potential to have a deleterious effect on industry-wide share prices.
- C. In the event that 2A or at least three of the indicators referenced in 2B are evidenced the staff or a member of the Investment Committee may bring the matter before the Investment Committee for due diligence and consideration. This due diligence will include:
 - (1) Analysis by the staff and/or third-party experts that the indicators are evidenced and have the potential to adversely impact the specific industry.
 - (2) Identification and listing of the individual companies in the specific industry based upon the definition adopted by the Investment Committee.
 - (3) Analysis of the impact the benchmark modification is expected to have upon total portfolio risk/return characteristics.
 - (4) Analysis of the expected costs associated with implementation of the benchmark modification.
 - (5) A timetable for review of the benchmark modification.

Executive Summary

The California State Teachers' Retirement System (CalSTRS/System) on May 3, 2000 adopted a Benchmark Modification Policy. The CalSTRS Investment Committee (Board) instructed its Staff and Pension Consulting Alliance, Inc. (PCA) to provide written analysis specific to the tobacco industry as it pertains to the Benchmark Modification Policy (Policy).

Due diligence was to determine whether a change in CalSTRS' existing benchmark(s) would be in the economic interest of the System, as determined by specific indicators provided in the Policy. "Economic interest" is defined as when either: 1) a more cost efficient alternative is available, or 2) an industry or sector is exposed to economic risk.

This report focuses on the latter as it is of particular relevance to the tobacco industry. Economic risk indicators, as outlined in the Policy, include product liability judgments, industry-wide bankruptcy filings, regulatory and/or legislative actions, as well as "deleterious" effects of institutional policy decisions. Our findings indicate that all four of these indicators are evidenced, thereby, meeting the minimum requirement for benchmark modification that at least three of four be present.

The following report is organized in the same format as outlined in the Benchmark Modification Policy.

Economic Risk Indicators

Paragraph 2B of the Policy reads:

2B. "When an industry or sector (component) of the benchmark is exposed to economic risks that are of such a degree that the future economic viability of that industry or sector is in doubt."

Section 2B then discusses more specific criteria (subcomponents) used to determine whether the "economic viability" of an industry or segment is in doubt. The next several paragraphs review these specific sub-components in the context of the tobacco industry.

"(1) The industry, not an individual company, shares common exposure to product liability judgments (including, but not limited to, potential judgments involving overwhelming punitive damage awards), settlements, and ongoing litigation that have the potential to exceed the industry's net worth."

The aggregate net worth of the tobacco industry is hard to estimate as stakeholders in tobacco litigation often cite vastly different dollar amounts. (Though, during the highly publicized 1997 talks between state attorneys generals and the tobacco industry, often a figure of approximately \$370 billion was suggested as a total.)¹ What's more, comprehending the impact of potentially huge punitive damage awards (or any other catastrophe) on an industry's economic viability, as measured by net worth, is also difficult. As Neil A. Doherty, Wharton School of the University of Pennsylvania, points out, "catastrophic events such as

¹ Pegasus.Rutgers Education website, "Parties, Interests, and Alternatives: Dispute Resolution in the Realm of Tobacco Litigation."

Hurricane Andrew and the Northridge earthquake have imposed costs on the insurance industry in an order of magnitude not thought possible only a decade ago.”²

The most publicized and perhaps the most crucial issue in the determination of the long-term viability of the tobacco industry is taking place in Florida via a class action suit, *Engle vs. R.J. Reynolds* (Engle). The jury has already found the industry guilty and is currently in the process of assessing the amount of punitive damages, a decision that is expected by the end of June 2000. Various tobacco lawyers and industry experts say that the jury could award damages as high as \$300 billion.³ Should huge punitive damages be awarded to Florida smokers, cigarette makers (should they lose their appeals) would have to post a bond to ensure money is there to pay smokers. The amount of the bond at this point is unclear.

The dollar amount of damages to be paid out by either an individual tobacco company or a group of tobacco companies is often contingent upon its net worth. However, determining a company's net worth can prove to be a daunting task. For example, in *Whiteley vs. Philip Morris*, a forensic economist was brought in to testify that R.J. Reynolds appeared to underestimate its net worth in documents produced at the trial. Economist Robert Johnson told jury members that in an unaudited financial statement R. J. Reynolds claimed its net worth for 1999 was \$5.3 billion. Johnson then reviewed their SEC 10K filing which showed that R.J. Reynolds had \$1.2 billion in cash alone. Reported total assets for 1999 were \$14.4 billion and sales were \$7.6 billion or \$21 million a day.

Select Tobacco Company Financials

Company	1999 Revenue	Total Assets*	Total Shareholder Equity*
Philip Morris	\$7,675	\$61,381	\$15,305
Loews Corp	\$4,223	\$14,746	\$9,978

- As of 12/31/99. Information obtained using 10-K statements on EDGAR database web-site.

No doubt, given the plethora of cases pending against the tobacco industry, there is potential that the liability of the judgments of these suits could exceed the net worth of the entire industry. However, as David J. Adelman, tobacco analyst for Morgan Stanley Dean Witter reminds us, it is important to note that in some jurisdictions the law prohibits a punitive damage award to exceed a company's net worth. In the event of bankruptcy, any bonds that would have been required, no matter their size, may be waived by the bankruptcy court.

The next sub-category covering economic risks is the concept of industry-wide bankruptcy filings (below).

Sub-component No. 2

“(2) Significant threat of industry-wide bankruptcy filings.”

Bankruptcy law exists so that creditors of an entity unable to cover its debts have recourse to the development of a supervised resolution, with some measure of equality. A plan can provide for either: 1) the distribution of assets or 2) an allowance to stay in business (in order for future revenues to cover the debt amount). Significant judgments against the tobacco industry may result in a strong economic impetus for tobacco companies to declare bankruptcy. The reasoning behind this course of action is that upon filing bankruptcy, though assets are immediately frozen, a company's legal proceedings are also put on hold, thereby

² Financial Institutions Center / Wharton School of the University of Pennsylvania Website, “Financial Innovation in the Management of Catastrophe Risk”, December 1998.

³ Guardian Unlimited / Guardian Unlimited Co. UK. Website, “Big Tobacco in the Balance”, Heather Connon, May 7, 2000.

allowing tobacco companies to avoid making any settlement payments. It would be the responsibility of the bankruptcy court (a federal court with nationwide jurisdiction) to determine how to best preserve a company's assets for the benefit of all the creditors. (Equity shareholders could lose-out entirely.) It is possible that this court would find that the best way to do this would be to allow for an appeal of the case.⁴

If there are appeals, and they are unsuccessful, then the court would have to decide how to prioritize all claims against these businesses. Often this is determined by which claims were made first, probably based on date of judgment. In this event, the vast majority of assets distributed would be to those states that participated in the Master Settlement Agreement (MSA). Therefore, as a consequence of this possibility, plaintiff attorneys and their clients, particularly those involved in class action suits, may lose out entirely on any amounts awarded from their particular lawsuits.

States, meanwhile, including those a part of the \$206 billion MSA agreement, also have reason to *encourage* the ongoing profitability of companies within the tobacco industry. First, MSA payments are scheduled to be made to the 46 states over the next 25 years. It is doubtful that, in the event of industry-wide liquidation, these states would receive the agreed-upon settlement. Second, several states receive a large amount of taxes from those companies headquartered within their borders. Virginia, where Philip Morris is located, offers the best example. Not only does Philip Morris pay millions in state taxes each year, it also employs almost 7,000 people. Governor Jim Gilmore has responded to recent legal and legislative events by going as far as introducing state legislation in an effort to protect Philip Morris. This was done by sponsoring a bill that would put a \$25 million cap on bonds for any in-state company, including those bonds assessed in other states.⁵ Though many legal experts question the constitutionality of such legislation, other states are responding almost as quickly. For example, the Florida Legislature recently approved a measure aimed at protecting tobacco companies by itself capping the bond amount companies would have to put up to appeal damages at \$100 million, or 10 percent of their net worth.

This point has become such a concern to those participating in the tobacco settlement that the Tobacco Products Liability Project (TPLP), funded from a grant to Northeastern University by the National Cancer Institute, is holding a conference on June 3, 2000 to discuss this exact issue.

Along with liability exposure and the threat of bankruptcy are regulatory and legislative actions that could also effect the long-term viability of the tobacco industry. The next section, sub-component No. 3, addresses these concerns, many of which are being strongly influenced by recent events.

Sub-component No. 3

“(3) Regulatory and/or legislative actions that have the potential to substantially impact industry-wide earnings.”

Most observers agree that the tobacco industry is subject to many regulatory and/or legislative actions that have the potential to substantially impact industry-wide earnings. As mentioned in the prior section, there are many pending actions, both on the state and federal level, some of which could potentially hinder the tobacco industry while, interestingly, others are in the industry's favor. It is important to note that many in the analyst community believe

⁴ Sanford C. Bernstein & Co., Inc., Bernstein Research, “Tobacco Stocks: Waiting for the Litigation Smoke to Clear”, Pecoriello, Campagnino, January 2000.

⁵ Sun-Sentinel / Sun-Sentinel website, “Virginia moves to protect tobacco company's assets from smoking trial in Miami”, Terri Somers, February 29, 2000.

that over the next 12 to 18 months most of these suits will be settled and that the earnings of tobacco companies will no longer be subject to the present amount of legal risk.

Probably the most recognized and successful anti-tobacco efforts made at the state-level are “anti-smoking” campaigns which are targeted at reducing consumption of cigarettes by teenagers. For example, smoking by teens in Florida dropped significantly after an aggressive campaign started in 1998. As reported by The Centers for Disease Control and Prevention, the number of middle school students who said they smoked dropped from 18.5% to 15% while for high school students the rate fell from 27.4% to 25.2%.⁶ Complementing this type of effort, states are also focusing on tobacco production, excise taxes and no-smoking policies, all of which could negatively impact the tobacco industry in terms of reduced demand.

The most notable recent suit was that brought by the Food and Drug Administration in an effort to assert jurisdiction over the tobacco industry. In a major defeat, though anticipated, on March 31, 2000 the US Supreme Court ruled 5-4 that the US FDA may not regulate tobacco products as drug delivery devices.⁷

Another attempt, at the federal-level, is one being brought under three federal statutes: MSP (Medicare Secondary Payers Act), MCRA (Medical Care Recovery Act) and RICO (Racketeer-Influenced Corrupt Organizations Act). Filed on September 22, most legal experts believe that the RICO suit is the most serious in that the government is seeking remission of retroactive profits. Most Wall-Street analysts believe, however, that a judgment in favor of the plaintiff is highly unlikely.⁸

It is worth mentioning that several international cases are also pending. One example is the Canadian government suit against RJ Reynolds Holdings Inc. seeking \$1 billion in damages. Other cases involve foreign governments seeking third-party reimbursement suits, primarily for the recovery of national healthcare expenses related to tobacco.⁹

Primarily for reasons already mentioned, several states have introduced legislation that would protect the assets of tobacco companies if a catastrophic ruling against them occurred (primarily, Henley). Both Virginia and Florida are attempting to put a cap on the amount of any bonds that may be assessed in the event of a substantial loss.

The next consideration that the Board has elected to consider is the potential effects of institutional investors’ responses to developments in the tobacco industry.

Sub-component No. 4

“(4) Policy actions in the institutional investor community that, in aggregate, have the potential to have a deleterious effect on industry-wide share prices.”

Divestiture of tobacco holdings by the institutional investor community has taken place sporadically over the last 20 years. This movement gained momentum during the late 1990’s as several large public pension funds, including several prominent state pension funds, voted to divest. During the last two years (as of December 31, 1999) the S&P 500 Tobacco Stock Composite, as constituted by BARRA, fell minus (23.1%). However, although the largest, the US institutional investor community is just one of many worldwide. Any decisions that result

⁶ CNN Interactive website, “Florida teen smoking drops since anti-tobacco campaign”, April 1, 1999.

⁷ Tobacco Resource Center Inc. & The Tobacco Products Liability Project / Northeastern University School of Law, (No Date).

⁸ Based on internally generated research.

⁹ The Washington Post / Join Together Online website, “Canada Sues RJ Reynolds”, David Segal, December 22, 1999.

in cash outflow from a certain sector or industry, even if it is fairly homogenous across the US, may result in those securities becoming relatively more attractive to foreign investors. Of course, one can use efficient market theory across any spectrum. But, what makes this scenario of particular relevance is that US institutional investors are often seen as more anxious than foreign investors, who are given credit for having longer time horizons. In recognition of this fact, Philip Morris is currently in the process of trying to sign up more institutional investors in Europe.

In addition, according to tobacco analyst, David Adelman, other factors should be considered in trying to assess the impact of policy decisions on stock prices. He suggests that given the tobacco industry's history, both recent and further into the past, that a couple of developments might be seen as having an insulating effect; in particular,

1. The tobacco industry has been exposed to legal and regulatory risks for a very long time; and
2. Tobacco companies have recently been in the process of repurchasing their own shares.

This concludes the portion of this report covering benchmark modification indicators as a determinate of whether further action, or due diligence, is necessary for the tobacco industry. The next section takes a look at some issues identified in part C of the Policy, which may be premature, but that may also be of particular relevance with regards to the tobacco industry.

Part C Due Diligence

"In the event that at least three of the above-referenced indicators are evidenced the staff or a member of the committee may bring the matter before the Investment Committee for consideration of due diligence."

The act of conducting due diligence, as indicated by the Policy, has been broken up into five distinct parts (as presented below).

- 1. Analysis by the Staff and/or third-party experts that the indicators are evidenced and have the potential to adversely impact the specific industry.**

In conjunction with our own research, and based on previous reports put forth by the IRRC and BARRA, PCA believes indicators are evidenced that have the potential to adversely impact the tobacco industry.

- 2. Identification and listing of the individual companies in the specific industry based upon the definition adopted by the Investment Committee.**

Below is a summary of the industry classification methodology used by BARRA.

BARRA Industry Classification Methodology¹⁰

BARRA classifies companies into industries using three attributes: percentage of revenue, percentage of assets, and percentage of operating income. Following are the exact steps involved in the process (as identified by BARRA):

1. Using proprietary data sources, BARRA determines the proportional contribution of each industry to a company's revenues, assets, and operating income. (For example, Industry 1 represents 60% of company revenues, Industry 2 represents 20% of company revenues, etc. The analysis is performed using the same type of assets and operating income.)

¹⁰ Source: BARRA

2. BARRA then applies a proprietary weighting algorithm to the revenue, asset, and operating income contributions within each industry. BARRA indicated revenues, in particular, received more than a 50% weighting.
3. For each industry, the weighted contribution are added together to determine the overall contribution of each industry to a company's overall business.
4. Rankings are established for overall industry contributions.
5. The industry with the largest overall contribution receives the "primary industry" classification in BARRA's methodology.

Note, due to the construct of this methodology, a company's primary industry classification can be less than 50% of a company's business activity.

Sample Listing of Tobacco Stocks*

Domestic

UST Inc.
 Dimon Inc.
 Loews Corp
 Universal Corp VA
 Schweitzer-Maudit Int
 Reynolds R J Tob Hldgs
 Philip Morris Cos Inc

International

Nobleza Picardo
 BAT Industries Australia
 Austria Tabak
 Cia Souza Cruz
 Amer Corp
 Seita
 Papastratos Cig
 Japan Tobacco
 BAT Industries
 RJR Reynolds BHD
 Grupo Carso
 Rembrandt Group
 Swedish Match
 Hanson

* Stocks listed are those used in BARRA's latest research update on transaction costs of tobacco divestiture done for CalSTRS. The list is derived from STRS' holdings and the Eighth Edition of IRR's Tobacco Industry report

3. Analysis of the impact of the benchmark modification is expected to have upon total portfolio risk/return characteristics.

BARRA RogersCasey analyses provide for the quantitative assessment of risk/return characteristics resulting from benchmark modification.

4. Analysis of the expected costs associated with implementation of the benchmark modification.

BARRA RogersCasey analyses provide for the quantitative assessment of costs associated with implementation of the benchmark modification.

5. A timetable for review of the benchmark modification.

The Board has adopted a schedule for review of benchmark modification on an annual basis or as otherwise needed.